IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1979

No. 79-463

CITY OF BETHEL, ALASKA, AND
COMMUNITY LIQUOR SALES, INC.
Petitioners,

v.

UNITED STATES OF AMERICA,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

JOSEPH H. THIBODEAU
777 Steele Park
50 South Steele Street
Denver, Colorado 80209
(303) 320-1250

Counsel for Petitioners

INDEX

CASES CITED

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The petitioners, City of Bethel, Alaska, and Community Liquor Sales, Inc., pray that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Ninth Circuit entered herein on April 11, 1979.

Opinion Below

The opinion of the Court of Appeals, reported at 594 F.2d 1301, and the Court's order denying rehearing, appear in the Appendix. The opinion of the District Court for the District of Alaska was not reported.

JURISDICTION

The judgment of the Court of Appeals, reversing the Trial Court's finding that the revenue in question was exempt from federal income tax, was entered on April 11, 1979. A timely petition for rehearing was denied and Order entered on June 21, 1979. Jurisdiction is invoked pursuant to 28 U.S.C. § 1254(1).

QUESTIONS PRESENTED

1. Is the federal taxation of income derived by Community Liquor Sales, Inc., an instrumentality of the City of Bethel, unconstitutional under the Tenth Amendment to the United States Constitution?

2. Did the income derived during the calendar years 1969 through 1971 by Community Liquor Sales, Inc., a nonprofit Alaska corporation completely controlled by the City of Bethel, "accrue" to the City within the meaning of Section 115(a) of the Internal Revenue Code of 1954, as amended?

Constitutional and Statutory Provisions Involved

U.S. CONST. amend. X

> The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States, respectively, or to the people.

Internal Revenue Code of 1954, as amended, Section 115(a), 26 U.S.C. §115(a):[1]

[1]In 1976, this subsection was amended to delete the words "or Territory" and redesignated § 115. Act of Oct. 4, 1976, Pub. L. 94-455, Title XIX, § 1901 (a)(19), 90 Stat. 1766. Since petitioners' claim arose prior to 1976, we refer to § 115(a).

> (a) General Rule — Gross income does not include — (1) income derived from any public utility or the exercise of any essential governmental function and accruing to a State or Territory, or any political subdivision thereof, . . .

STATEMENT OF THE CASE

A. Facts

The matter below was instituted as a tax refund action by Community Liquor Sales, Inc., and Bethel, Alaska, for the recovery of federal income taxes in the aggregate amount of $36,538.87, plus interest attributable to calendar years 1967-1971.[2] On May 25, 1977, judgment was entered in the United States District Court for the District of Alaska (the Honorable James M. Fitzgerald) in favor of petitioners. On April 11, 1979, the Court of Appeals for the Ninth Circuit in *City of Bethel v. United States*, 594 F.2d 1301 (1979), reversed the Trial Court.

From documentary and testamentary evidence presented at trial, the following was established:

By a vote of the people of the City of Bethel, on October 4, 1966, the creation and maintenance of Community Liquor Sales, Inc. (or a like entity) was authorized, and, in fact, mandated. Bethel, historically, had significant "bootleg" liquor sales and alcoholism problems. In an effort to deal with these problems, as well as to provide for the general public health, safety, and welfare of the City, on December 5, 1966, Community Liquor Sales, Inc., was created and organized to act as a nonprofit Alaska corporation and agent of the City.

[2]Refunds for the years 1967 and 1968 were denied on summary judgment because the statute of limitations had run. Consequently, the petition affects only the years 1969 through 1971.

The corporation was expressly authorized and directed to implement the vote and to establish a nonprofit community liquor store. Incidental proceeds derived from the operation of the store, over and above the expenses of operation, were earmarked for the City.

The corporation was not organized for pecuniary profit, nor did it have any power to issue certificates of stock or declare dividends. No part of its net earnings inured to the benefit of any member or trustee. The balance of all monies received by the corporation from operations, after the payment in full of all debts and obligations, were to be distributed to the City, exclusively, for the use and promotion of the general welfare of the City and its inhabitants. In the event of the dissolution of the corporation, all of the business, property and assets of the corporation were to be distributed to the City. In no event did the assets or property of the corporation, or the proceeds thereof, go to donors or members. Indeed, no part of any proceeds, income or profit ever was, or could have been, realized by any individual or entity other than the City, its creditors or approved payees.

Proper accounting procedures and principles reflected that, at the close of all operating years in question (1967-1973),[3] unappropriated retained earnings were accrued in the approximate annual amounts of $20,206, $15,100, $32,523, $3,823, $7,136, $40,022, and $34,937, respectively. These amounts are truly reflective of all net profits derived by the corporation from all operations. With the exception of approximately $90.00 (which, for a brief period thereafter, through oversight, remained in the corporation's operating checking account, subject to being drawn down at any time by Bethel pursuant to its absolute right to do so), these

[3]The City voted to go "dry" after 1973. For tax purposes below, the years 1967-1971, only, were involved; 1972 and 1973, in aggregate, representing an additional $100,000 in tax, plus interest and penalties, are pending disposition in the United States Tax Court, the result of which disposition will, of course, be reviewable by the Ninth Circuit.

amounts were distributed in full to the City during calendar years 1974 and 1975.

B. Basis of Petition

1. "Accrual"

For purposes of this petition, issue is taken, first, with that portion of the Court of Appeals' decision and opinion which provides that income "did not accrue" to the City because '[t]he income was never actually transferred to Bethel from CLS, nor do any bookkeeping entries reflect that the income was owed to Bethel". 594 F.2d at 1302.

Petitioners respectfully take exception to that conclusion.

The uncontroverted expert testimony (field of accountancy, with a subspecialty in municipal accounting) of Mr. Vernon R. Johnson, a C.P.A. with the Anchorage office of Peat, Marwick, Mitchell & Company, was presented at the trial below. Mr. Johnson confirmed, as reflective of the City's absolute vested right to the revenues in question, the propriety of the accounting method adopted by the City and the corporation. Mr. Johnson described the relationship between the two, for accounting purposes, as an "enterprise fund" and testified that such "funds" are common devices employed in municipal accounting precisely for the purpose of reflecting such an absolute right. From an accounting viewpoint, Mr. Johnson maintained that the City was at all times possessed of an enforceable right to all net receipts from the corporation. He further testified that the accounting method used by the corporation ("retained earnings") to so reflect this right was the customary method employed by "enterprise funds" for that purpose. He noted that it would not be customary for such "funds" to reflect an enforceable right of this kind in the manner most often used in many other contexts; to wit: accounts payable and recievable.

On audit of both the City and the corporation, Mr.

Johnson found that all revenues derived from the corporation's operation were properly disbursed as: (1) legitimate costs and expenses of operation; (2) payments made to City creditors at City Council direction; (3) contributions made, with either City Council direction or approval, to charities or other public causes; or (4) direct contributions to the City. They were put to no other use.

2. Constitutional Immunity

Secondly, issue is taken with the Court of Appeals' failure to address the issue of "constitutional immunity". Petitioners respectfully submit that Community Liquor Sales, Inc., as an instrumentality of a political subdivision of the sovereign State of Alaska, is immune from federal taxation under the Tenth Amendment to the United States Constitution. The opinion rendered by the Ninth Circuit fails to address this issue. It addresses only the "accrual" issue. The constitutional issue transcends all others, and, it is submitted, should have been considered.

REASONS FOR GRANTING THE WRIT

1. The Court of Appeals has decided an important question of federal law under Section 115(a) of the Internal Revenue Code of 1954, as amended, which question has not been, but should be settled by this Court, and which decision is in conflict with decisions of other Courts of Appeals.

The question at issue below was: did income "accrue" to a political subdivision so as to be exempt from Federal income taxation pursuant to Section 115(a) of the Internal Revenue Code of 1954, as amended?

The meaning of "accruing" in I.R.C. § 115(a) and its predecessor versions has been particularly troublesome in the context of profit and nonprofit corporations controlled by political subdivisions.

The Ninth Circuit has herein adopted an interpretation of the term neither contemplated by statute nor endorsed by judicial precedent. In its view, either income must be actually received by the political subdivision, or bookkeeping entries must exist in financial records to demonstrate "accrual".

This interpretation conflicts with those of *Omaha Public Power District v. O'Malley*, 232 F.2d 805 (8th Cir. 1956), *cert. denied* 352 U.S. 837 (1956) — which held that "accrue" means "to come into existence as an enforceable claim, or to vest as a right" (232 F.2d at 809), and of *Decatur Water Supply Company v. Commissioner*, 88 F.2d 341 (7th Cir. 1937) and *Jamestown and Newport Ferry Company v. Commissioner*, 41 F.2d 920 (1st Cir. 1930), which Circuits have focused on the degree of control exercisable by the municipality and on the nature of the enterprise in question. Lower courts have been improvising on a case-by-case basis. See, eg., *Maryland Savings-Share Insurance Corporation v. United States*, 308 F.Supp. 761 (1970) rev'd on other grounds 400 U.S. 4 (1970). Under any test, other than that adopted by the Ninth Circuit herein, petitioners would have prevailed as, indeed, they did in the opinion of the Trial Court.

Moreover, notwithstanding that the Trial Court had made a clear finding of fact that the income did "accrue" to the City, the Ninth Circuit, in a pronounced departure from accepted principles of appellate review, totally reversed this finding, without so much as a comment upon the sufficiency of the evidence educed in connection therewith.

Municipal utilization of corporate vehicles in carrying out governmental functions is commonplace. In addition, therefore, to the conflict between the Circuits effected by the Ninth Circuit decision, review of this matter by this Court is indispensable to clear direction in the federal income taxation of a widespread and critically important practice.

2. The decision below is in patent conflict with the Tenth Amendment to the United States Constitution.

The decision below effects a direct burden upon an instrumentality of a political subdivision of one of the sovereign states.

The Tenth Amendments provides that:

> The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people.

The amendment reserves to the States all powers and responsibilities not otherwise delegated to, and conferred upon, the Federal Government. In doing so, it speaks of constitutional rights and privileges (accruing to and exercisable by the States and, of course, their political subdivisions) of the highest order. It requires that these be afforded respect of a commensurately high order; and, indeed, that they be preserved inviolate.

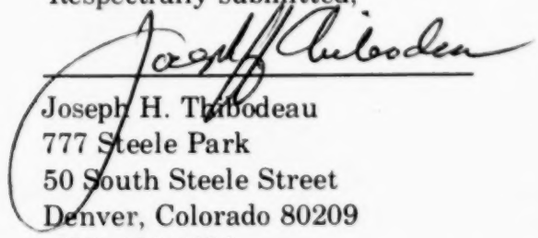
At least as early as 1873, in *United States v. Baltimore & Ohio R.R. Co.* 84 U.S. 332 (1873), the constitutional principle was established that, owing to the concurrent powers of the Federal and State Governments, instrumentalities of the several States (and their subdivisions) were to be held immune from federal income taxation. See also, *Jamestown & Newport Ferry Co. v. Commissioner of Internal Revenue Service,* 41 F.2d 920 (1930). Such instrumentalities were recognized as means employed in the operation of government, preservation of existence, and execution of duty preserved and delegated under the United States Constitution. Their taxation has historically been regarded as an unconstitutional burden.

The proposed tax herein involved, in violation of the Tenth Amendment, imposes a direct burden upon the City. Notwithstanding the Trial Court's finding that Community Liquor Sales, Inc., was an instrumentality of the City (in finding in the corporation's activity the exercise of an "essential governmental function"), and notwithstanding the Appellate Court's adoption of the same finding, the latter, nonetheless, upheld the imposition of a direct burden, in the form of the tax in question, upon that instrumentality, and through it, upon the City.

CONCLUSION

For the foregoing reasons, a writ of certiorari should issue to review the judgment and opinion of the Ninth Circuit.

Respectfully submitted,



Joseph H. Thibodeau
777 Steele Park
50 South Steele Street
Denver, Colorado 80209
(303) 320-1250
COUNSEL FOR PETITIONERS

APPENDIX A

IN THE UNITED STATES COURT OF APPEALS,
NINTH CIRCUIT

CITY OF BETHEL, ALASKA, AND COMMUNITY LIQUOR SALES, INC.,
Plaintiffs-Appellees

v. No. 77-3086

UNITED STATES OF AMERICA,
Defendant-Appellant.

APRIL 11, 1979

A tax refund action brought by a city in the United States District Court for the District of Alaska, James M. Fitzgerald, J., resulted in a finding that revenue in question was exempt from federal income tax. The Government appealed. The Court of Appeals, J. Blaine Anderson, Circuit Judge, held that where the city organized nonprofit corporation, managed by three trustees, to sell alcohol, and, although city could have had trustees distribute profits to city and although assets of corporation were eventually turned over to city, on dissolution of corporation with advent of local prohibition, profits were not in fact credited to city by any bookkeeping operation, there was no "accrual" of income to the city, but, rather, income was taxable to such corporation.

Reversed with directions to enter judgment for United States.

1. Internal Revenue — 794

Right en futuro to receive assets of corporation upon dissolution cannot be equated to present accrual of the income, for income tax purposes. 26 U.S.C. (I.R.C. 1954) (1970 Ed.) § 115(a).

2. Internal Revenue — 794

Control of corporation does not automatically cause income to accrue to controlling entity, for income tax purposes. 26 U.S.C. (I.R.C. 1954) (1970 Ed.) § 115(a).

3. Internal Revenue — 794

Where city organized nonprofit corporation, managed by three trustees, to sell alcohol, and, although city could have had trustees distribute profit to city and although assets of corporation were eventually turned over to city, on dissolution of corporation with advent of local prohibition, profits were not in fact credited to city by any bookkeeping operation, there was no "accrual" of income to the city, but, rather, income was taxable to such corporation. 26 U.S.C. (I.R.C. 1954) (1970 Ed.) § 115(a).

M. Carr Ferguson, Asst. Atty. Gen., Washington, D.C., Ann B. Durney, Washington, D.C., for defendant-appellant.

Joseph H. Thibodeau (argued), Nelson, Harding, Marchetti, Leonard & Tate, Denver, Colo., for plaintiffs-appellees.

On Appeal from the United States District Court for the District of Alaska.

Before WRIGHT, GOODWIN and ANDERSON, Circuit Judges.

J. BLAINE ANDERSON, Circuit Judge:

This is an appeal from a tax refund action brought by City of Bethel, Alaska (Bethel), and Community Liquor Sales, Inc. (CLS). After a bench trial, the district court found that the revenue in question was exempt from federal income tax under section 115(a) of the Internal Revenue Code

of 1954.[1] We reverse because the revenue had not accrued to Bethel and therefore was taxable income to CLS.[2]

FACTS

For years Bethel has been plagued with alcohol-related problems. In 1965 the citizens of Bethel voted to prohibit the sale of alcohol in the City. The problems continued, however, for alcohol purchased legally elsewhere was readily available in Bethel. In 1966 the citizens voted to end prohibition.

To control the sale of alcohol, CLS was incorporated and licensed as the sole licit supplier of alcohol in Bethel.[3] CLS was a nonprofit corporation managed by three trustees, all of whom served at the pleasure of the Bethel City Council. The Articles of Incorporation expressly denied to the corporation the power to issue stock and declare dividends. CLS's profits, with minor exceptions, were retained to purchase inventory until CLS was dissolved in 1973 when the citizens again voted to prohibit the sale of alcohol. The assets of the corporation were then turned over to Bethel.

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[1] Section § 115(a) provides:

"(a) *General rule.* — Gross income does not include —

(1) income derived from any public utility or the exercise of any essential governmental function and accruing to a State or Territory, or any political subdivision thereof, or the District of Columbia; or

(2) income accruing to the government of any possession of the United States, or any political subdivision thereof."

26 U.S.C.A. § 115(a).

In 1976, this subsection was amended to delete the words "or Territory" and redesignated § 115. Act of Oct. 4, 1976, Pub.L. 94-455, Title XIX, § 1901(a)(19), 90 Stat. 1766. Because Bethel's refund claim is governed by the wording of § 115(a), we refer to the exemption as § 115(a).

[2] Appellant also contends that § 115(a) is inapplicable because the income was not derived from an essential governmental function. Our disposition of the accrual issue obviates resolution of this additional contention.

[3] The City Council realized the liquor store would generate a profit, yet this was not the primary motivation for opening a City-controlled store.

From 1967 through 1971,[4] CLS filed returns and paid income tax on its net profits. During those years CLS and Bethel maintained wholly separate books and accounts. CLS did pay licensing and rental fees to Bethel,[5] but CLS's profits were not listed as an account receivable or other asset on Bethel's financial statements.

ANALYSIS

[1] Section 115(a) exempts from income tax income "accruing to a State . . . or any political subdivision thereof . . ." *See generally* Tucker and Bombro, *State Immunity from Federal Taxation: The Need for Reexamination,* 43 Geo. Wash. L.R. 501 (1975). CLS was distinct legal entity. The income was never actually transferred to Bethel from CLS, nor do any bookkeeping entries reflect that the income was owed to Bethel. The Eighth Circuit has held, and we agree, that a right en futuro to receive the assets of a corporation upon dissolution cannot be equated to present accrual of the income. *Omaha Public Power District v. O'Malley,* 232 F.2d 805 (CA 8), *cert denied,* 352 U.S. 837, 77 S.Ct. 57, 1 L.Ed.2d 55 (1956).

[2] Through its power of appointment, Bethel did control CLS, but control of a corporation does not automatically cause the income to accrue to the controlling entity. *Bear Gulch Water Co. v. Commissioner of Internal Revenue,* 116 F.2d 975 (CA 9), *cert. denied,* 314 U.S. 652, 62 S.Ct. 99, 86 L.Ed. 523 (1941). In *Bear Gulch* the court held that a corporation's retained earnings do not accrue to a government entity for purposes of section 115(a) even though the corporation's stock is wholly owned by the government entity.

[4] Refunds for the years 1967 and 1968 were denied on summary judgment because the statute of limitations had run (R.61). Bethel has not appealed this ruling; consequently, the instant appeal affects only the years 1969, 1970, and 1971.

[5] Neither CLS nor Bethel paid tax on these amounts.

Here, Bethel could have exercised its control to effect accrual by having the trustees distribute CLS's profits to the City,[6] but it never did.

[3] If the income had been transferred to Bethel coffers and then expended to finance CLS's operations, a different result might follow, for then the money undeniably would have accrued to Bethel. Instead, the income was retained by CLS and shown as an asset on its financial statements. No offsetting debit to Bethel was reflected in CLS's financial records, nor did Bethel's financial record reflect any right to receive income from CLS. Inasmuch as the two entities were operated separately and reported their income separately, the income of one cannot be said to be the income of the other without more. Here, the income was never received by the City, and there is no indication either the City or CLS recognized a present obligation to the City from CLS. No matter what expectation the City might have had that it would receive distributions from CLS, the amounts of those receipts could not be fixed with any reasonable certainty until the distributions were actually made. Therefore, there is no basis for inferring accrual as that term is ordinarily defined.

Bethel asks us to expand the definition of accrual beyond its ordinary meaning. Yet, as appellant points out, the Tax Court has strictly construed the term, suggesting that only actual receipt will suffice. *Troy State University v. Commissioner,* 62 T.C. 493 (1974). We need not decide whether the accrual criterion should be narrowly or broadly construed, for under any definition Bethel has failed to offer sufficient objective evidence to support its claim that the income accrued to it each year.

[6] This was authorized by the Articles of Incorporation, Article II:

"The balance, if any, of all money received by the corporation from the operations of its liquor store, after the payment in full of all debts and obligations of the corporation of whatever kind or nature, shall be distributed exclusively to the City of Bethel, Alaska, for use in promotion of the general welfare of the City and its inhabitants."

Appellees failed to satisfy their burden of proving the income should be excluded from gross income. On remand judgment shall be entered in favor of the United States.

REVERSED.

APPENDIX B

IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

CITY OF BETHEL, ALASKA, AND COMMUNITY LIQUOR SALES, INC.,
Plaintiffs-Appellee,
vs. No. 77-3086

UNITED STATES OF AMERICA, ORDER
Defendant-Appellant.

Before: WRIGHT, GOODWIN and ANDERSON, Circuit Judges.

The panel as constituted in the above case has voted to deny the petition for rehearing and to reject the suggestion for a rehearing en banc.

The full court has been advised of the suggestion for en banc rehearing, and no judge of the court has requested a vote on the suggestion for rehearing en banc. Fed. R. App. P. 35(b).

The petition for rehearing is denied and the suggestion for a rehearing en banc is rejected.

Filed June 21, 1979
Emil E. Melfi, Jr.
Clerk, U.S. Court of Appeals